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COMMENTS

on the presentation

by

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Charles Calomiris in his presentation gave us a thorough analysis of the current liquidity crisis, the causes that led to it and the factors that contributed to its amplification. The current liquidity shock is characterized as a collapse of confidence in the architecture of securitizations. Thus, a major shortcoming identified in this episode was that the capacity of the market to absorb risk was overestimated or as claimed by our speaker, was ignored on purpose. The novelty of the disintermediation process and the behaviour of rating agencies characterized by grade inflation and fee driven incentives have been brought forward as major elements underlying this failure.

The collapse of confidence and the risk allocation problems encountered during the recent turmoil reflect a number of factors related to the measurement and management of risk and, hence, are closely associated with regulatory policies. During my short intervention I will refer to 3 issues which touch upon considerations regarding regulatory practices. These are

a) Valuation practices
b) Effective harmonized global regulation
c) Regulatory changes under BASEL II

a) VALUATION ISSUES

Clearly, market based valuations and fair value accounting are desirable, as they foster transparency, discipline and accountability. Nevertheless, illiquidity can make valuation of many instruments problematic.

During the recent turmoil market liquidity for many financial products declined substantially, owing to uncertainty about the extent of the crisis and lack of market demand. In the absence of sufficient trading activity, price discovery based on observable market prices became more difficult.

As market conditions changed, price quotes given for a number of asset classes were considered to be problematic.

In addition, the ability of market participants to asses the valuations applied by individual institutions was very limited, as there are no widely accepted models to value complex asset classes and instruments, and there is lack of easily usable data for such a purpose.

These factors contributed to the uncertainty surrounding the valuation of assets and exacerbated the illiquidity of the secondary markets for these assets.

More importantly, the complexity of assets and the lack of a harmonized valuation framework appear to have prevented market driven transparency from bringing the necessary discipline to the market. The problems created by asymmetric information and adverse selection could not be solved through transparency, due to lack of generally accepted valuation standards. Such valuation problems make it difficult for market participants to obtain necessary information about exposures on a comparable basis.

In such circumstances, the signals conveyed by the voluntary disclosures become noisy, which implies that investors have doubts about the true incentives of the disclosing institutions. In other words investors have doubts that disclosures represent the true levels of exposures.

In this respect, a key question is how fair value measurement can best be made in the context of illiquid markets.

Hence it is important that regulators together with setters of accounting standards reach a common and harmonized view on a wide range of issues that need clarification and resolution in the area of valuation.

b) EFFICIENT AND EFFECTIVE GLOBAL REGULATION

The financial turmoil has demonstrated the complex interconnectivities of the present global financial system. There has been and there is still fast convergence of financial sectors and products which were once distinct. These interconnectivities have benefited both the industry and consumers in terms of efficiencies, innovation and choice.

In a global financial market spreading risks among many investors through securitization is easier to achieve. At the same time however, such risk dispersion enables the defaults originating in a local market to be spread across the globe. This form of contagion to other markets underscores the need for harmonized regulatory systems.

At present there are considerable differentiations and gaps in cross-border regulatory and supervisory structures. The roles and powers of various authorities within and across jurisdictions can differ considerably and indeed non-harmonized regulatory practices still exist.

The existing differences in supervisory practices largely reflect issues related to the implementation of the Basel II framework. In fact, a number of implementation issues are still in the process of being addressed by the Accord Implementation Group. It is worth noting that the Basel Committee on Banking Supervision in its press release of April 16 has noted the importance of prompt implementation of the Basel II framework. The following are indicative of the need for further progress in this area.

a) Different implementation time schedules with regard to Basel II still exist both in Europe and between Europe and the US
b) There are important home –host issues regarding Pillar II approval processes for banking groups with foreign subsidiaries. The Basel Committee has provided guidelines on home-host information sharing for effective Basel II implementation. The use of Supervisory Colleges to address Pillar 2 coordination issues has been proposed. Nevertheless the experience with Supervisory Colleges is mixed.
c) There exist differences across jurisdictions in regard to required disclosures.

So there is urgent need for further harmonization across jurisdictions.

c) FORTHCOMING REGULATORY CHANGES

We have seen that the turmoil triggered a number of policy responses. These include changes in the regulatory framework.

Earlier this year, the Financial Stability Forum asked the Basel Committee to produce by year end 2008 specific regulatory proposals on a number of issues. The Basel Committee on Banking Supervision on April 16, 2008 announced a series of steps in the context of the Basel II framework with a view to “make the market more resilient to financial shocks”

The main areas of supervisory actions are the following:

1. Changes in Capital Requirements

   The Committee will raise capital requirements for certain complex structured credit products (CDOs).

   Will strengthen the capital treatment of liquidity facilities to off balance sheet conduits

   It will strengthen capital requirements in the trading book.

2. Guidance on Risk management practices

   The aim is to establish the adoption of a comprehensive approach to firm wide risk management and the integration of risk management areas. To achieve this it is necessary to eschew the silo approach to risk management whereby each type of risk is assessed in isolation.

3. Strengthening management of liquidity

   The aim is to establish standards for the management and supervision of liquidity risks which will help banks to have strong liquidity cushions and to come through periods of stress and illiquidity. (stress tests, on and off. Balance sheet activity, contingent commitments)

4. Transparency and disclosure practices

The Committee has announced that it will take actions to promote enhanced disclosures relating to securitization exposures.

It is important to note that a prerequisite for market discipline under Pillar 3 is the availability of a transparent and coherent picture regarding disclosures. The standardization of market definitions and the harmonization of disclosure practices is critical in this respect. Such harmonized disclosure should provide sufficient information on areas such as risk management processes, liquidity risk management processes, valuation practices and funding requirements.

Some observations which are of relevance in view of the forthcoming regulatory changes:

1st observation

The continuing market upheaval highlights the importance of risk resulting from insufficient information. The expansion of structured credit products across global financial markets creates new challenges for investors with regard to the nature and the scope of the risks involved.

Under incomplete information and uncertainty complex products become increasingly risky, as their pay offs are very sensitive to minor changes in credit conditions. There is additional loss of information due to the separation of the end investor from the originator of the product. Moreover, the transfer of risk through securitization can create incentive problems and can lead to a reduction in the overall level of screening and monitoring, thus endogenizing risk creation.

2nd observation

The recent financial turmoil illustrated that the risk evaluation processes employed by credit institutions and the assumptions underlying risk measurement methods have not to been robust to changing market conditions.

A significant aspect of these weaknesses is that there has been an underestimation of the extent to which various types of risk become correlated in times of stress. Therefore it is desirable that risk management methodologies adopt an integrated approach and put emphasis on the interactions of various risk factors. These interactions should be appropriately taken into account when measuring risk.

The Basel Committee is currently working on methodologies that would improve the understanding among banks and investors of such interactions. However, these interactions are not always easy to model. For example, a topic of current research in financial and academic communities is the better understanding of the links between market risk and credit risk.

Last observation

The financial innovation and the associated complexity of the financial world have led to an increasing use of models in the area of risk measurement and valuation. In such circumstances a risk factor that has become relevant is the risk of error due to model inadequacies or what could be termed as´´model risk´´.

Sources of model risk, among others, include incorrect model specification due to missing risk factors and omission of important variables. Another source of model risk is implementation risk which can arise from mechanistic implementations of the model as a black box, from incorrect calibration of model parameters and from data problems related to lack of up to date information.

To mitigate model risk, it is necessary that model assumptions, model weaknesses and the scope of application are understood across the various layers in a financial organization.

It is also important to continuously evaluate models through appropriate methods such as recalibration , re-estimation, back testing and stress testing, with a view to adjust them in the presence of significant changes which affect the underlying assumptions.

Addressing these concerns is critical, both, to financial institutions and to regulators.

What about the future?

It seems that in the future the focus will probably be on more standardized products which are more transparent in design and economize on information costs.

Emphasis on standardization of products may facilitate improvements in market infrastructure, which in turn may lead to more reliable valuations.

More complex products which match specific investor needs will continue to be offered (less aggressively). For such tailored products the

lowering of the frictions and market imperfections observed during the turmoil may necessitate recognition of additional costs in areas such as information screening and provision of liquidity.